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CAPITAL ADEQUACY OF BANK BGŻ 31 DECEMBER 2013

WARSAW 2014

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A. INTRODUCTION

According to article 111 a. of the Baking Law of the 29th of August 1997 (tekst jedn. – Dz. U. z 2012r poz 1376, z późn. zm.) and according to Res. No. 385/2008 of the Polish Financial Supervisory Commission of the 17th of December 2008 with subsequent changes concerning detailed rules and the way of disclosing qualitative and quantitative information about capital adequacy by banks as well as the scope of information that should be disclosed, Bank Gospodarki Żywnościowej S.A. (referred to in this document as: the Bank or Bank BGŻ), is obliged to publish, in widely accessible form, quantitative and qualitative information about capital adequacy – excluding irrelevant information or information that, when disclosed, could have an disadvantageous impact on the Bank's position on the market (as it is understood by the law concerning protection of the competition and consumers), as well as information that is confidential under the law. The values in the report are presented on the highest consolidation level of the group in Poland. The Bank is also obliged to disclose information on securitized positions. Nevertheless as on the 31st of December 2013, there were no such positions in the Bank's portfolio.

Apart from that, according to article 111 a paragraph 1 point 2 of the Baking Law and according to appendix 1 to the Res. No. 385/2008 of the Polish Financial Supervisory Commission of the 17th of December 2008, the Bank presents information concerning variable elements of remuneration of persons from the Bank's management.

Bank BGŻ is the parent entity of the capital Group of BGZ S.A. As on the 31st of December 2013 the Bank's capital group includes: Bank BGŻ and Bankowy Fundusz Nieruchomościowy Actus sp. z o.o. which does not have any important impact on the Bank's financial condition nor Bank BGŻ's capital position. As on the 31st of December 2013, the Bank had due receivables from BFN Actus equalling to PLN 36.0 m. There are no legal obstacles for repayment of receivable by BFN Actus Sp. z o.o.. All subsidiaries were consolidated as on the 31st of December 2013.

Tab. Fully consolidated subsidiaries – 31.12.2013 in PLN thou.

name of a subsidiary	statutory capital in PLN thou.	share in statutory capital	activity
BFN Actus Sp. z o.o	1 510	100%	real estate purchase & sale
total	**1 510**	**100%**	

Tab. Equity reducing subsidiaries - 31.12.2013 in PLN thou.

entity	amount of reduction (PLN thou.)	activity	reason for reduction
BGŻ Leasing Sp z o.o.	35 052	leasing	shares
total	**35 052**		

B. AIMS AND RULES FOR RISK MANAGEMENT

B1. CREDIT RISK

Strategies and processes in credit risk management

The basic goal of the credit risk management policy of Bank BGŻ is the proper identification and measurement of credit risk that provides a firm framework for credit approval as well as the monitoring of clients' exposures and credit portfolio management. The important components of the Bank's credit risk management are the principles regarding crediting terms and conditions for individual transaction, principles for collateral management and principles concerning credit risk appetite. The credit risk appetite is an articulation of the level of credit risk the Bank is willing to accept or tolerate in pursuit of its business strategy. The Bank determines the expected level of credit risk appetite by setting Key Risk Indicators by sectors, products, business lines, clients groups. More detailed risk measures and the approach towards managing and limiting the credit risks at BGZ are set by:

1) "Key Credit Risk Limits and Control Structure BGZ"
2) "Concentration Limits".

Credit risk appetite, credit risk management policy and tools used for its implementation are accepted by the Bank's Management Board.

Organization of the credit risk management process

In order to ensure the efficient execution of tasks in the area of credit risk management the Balance and Risk Management Committee was created, with its Credit Policy, Monitoring and Control Subcommittee. Within the Bank risk management areas ere distinguished, i.e. Systemic Risk Area and Analysis and Credit Decisions Area. Within the risk management areas there are organizational units that are responsible, among other things, for:

- calculation of the internal capital and impairment of the financial assets,
- policy, procedures and methodology as well as monitoring of the credit portfolio,
- credit risk assessment and monitoring of credit exposures,
- loan administration and loan documentation,
- support to the employees from sales units in the area of credit risk issues.

Specialized organizational units are responsible for restructuring and recovery of loan receivables.

In the organizational structure of regional units of the Bank there is a Risk Division responsible for applying and realization of credit risk management rules and goals in regions.

Scope and types of risk reporting and measuring systems

In order to efficiently manage risk in the Bank a system has been introduced which delivers information about credit portfolio quality for the management. Based on information from Data Warehouse and transaction systems monthly, quarterly and semi-annual reports on credit portfolio quality are prepared taking into account:

- product structure, in particular institutional exposures related to real estate financing,
- business line structure,
- term structure,
- currency structure,
- collateral structure,
- industry structure,
- quality of products/segments (including the size of delays, migrations between classes of days overdue, vintage analysis, PD and LGD ratios),
- levels of impairment provisions,

- levels of write-offs,
- results of monitoring and vindication processes,
- policy deviations,
- LtV level.

Moreover, the Bank regularly monitors concentration limits, estimates provisions and calculates capital requirements.

Basic tools supporting the credit risk management process are:

- credit limits which set maximal acceptable credit exposure at particular decision levels,
- methods of assessment of economic and financial situation of clients,
- rating and scoring systems,
- system for monitoring of the Bank's exposure to risk,
- software for impairment calculation for financial assets,
- RAROC (credit value at risk estimation),
- Risk Based Pricing model.

Rules for using collaterals and risk mitigation techniques as well as strategies and processes of monitoring efficiency of collaterals and credit risk mitigation techniques

Principles of evaluation, establishing and monitoring of collaterals are defined in the Bank's internal regulations approved by the Management Board. These principles aim to ensure:

- an equivalent Bank's position in relation to other entities providing financing to a client,
- determination of market value of collateral and independent professional appraisal in case of mortgage,
- possibility to use collateral to reduce capital requirements or the basis for creating reserves,
- monitoring and update of collateral value within the whole crediting period, as well as calculation of LtV ratio in case of mortgage-back transactions.

Bank's internal regulations, especially models of collateral agreements, ensure formal correctness of accepted collateral and possibility to recover loan receivables.

B2. MARKET RISK

Market risk comprises foreign currency risk, interest rate risk, price risk, volatility and correlation risk. Existence of market risk is an imminent feature of trading book, where it is a main purpose of having the book in the first place, but it is present also in the banking book, as the effect of offering to the clients of products in different currencies, with different maturities and repricing schemes.

Interest rate risk is primarily associated with mismatch between repricing dates of Bank's assets and liabilities, but it is also connected with the risk of changes is shape of the yield curve, impacting directly net present value of current and future cash flows – fair value and interest streams – and in consequence changing the value of Bank's net equity; and basis risk, being the result of using non-market reference rates as a basis for pricing of selected products.

Price risk is connected with possibility incurring a loss by the Bank as a result of change in market price of instruments that are quoted on organised financial markets (e.g. exchange), in particular this concerns capital and debt securities. Market value of such instruments is not exclusively driven by e.g. interest rates levels, but is as well dependant on the way the market is organised, its liquidity and by specific (e.g. credit, reputation) risks connected with particular issuers.

Foreign exchange risk is a risk of change in value of assets, liabilities and off-balance transactions denominated in or indexed to foreign currencies, taking place as a consequence of change in market quoted rates of exchange.

Volatility and correlation risk is expressed through instability of financial market that fluctuates in a response to internal factors: supply and demand for particular instruments or risk types; and external: economic and political situation, changes in regulatory environment. Volatility risk, understood as an underlying instrument of options, is eliminated in Bank BGŻ through the policy of back-to-back hedging of non-linear positions. Correlation risk can be associated with instability of direction and strength of interdependencies between different risk factors that can lead to inefficiency of hedge strategies and changes in risk profile.

Risk management strategies and processes

Bank BGŻ, operating as a universal bank, services all types of clients: retail, corporates, public and budget entities, non-banking financial institutions as well as other banks. Apart from typical banking products (loans and deposits), it offers as well intermediation in trading financial market instruments for the clients and, in limited scope, runs its own investment and trading books.

In order to properly reflect specificity of positions, i.e. their purpose, dominant risks and applied book keeping rules; Bank BGŻ assigns all on-balance positions and off-balance transactions to either banking book or trading book. Precise criteria of this division are laid out in documents ("policies") introduced with appropriate Management Board resolutions; that specify purpose of the books, approved size, profile and types of taken risks, methods to estimate and limit those risks as well as competences and placement of various organizational units within the Bank in the process of generating, measuring, limiting and reporting of risk. Those documents are in line with recommendations of Financial Supervisory Commission and standards of Basel Committee on Banking Supervision. Additionally Bank establishes risk appetites, approved by Supervisory Board, that are maximum tolerated risk level associated with Bank's activity on financial markets. They have global and directional nature.

Banking book is composed of two portfolios: ALM and Money Market. ALM positions include the Bank's loan and deposit/account products reflected via Funds Transfer Pricing mechanism, non-interest bearing positions (equity, credit provisions, tangible and intangible assets, taxes, profit, etc.), the investment portfolio run to safely invest Bank's capital, own bond issues, long-term funding facilities and derivatives (used to manage structural interest rate risk), while Money Market portfolio is connected with liquidity management (current account in central bank, interbank deposits, liquid debt securities, IRS/CIRS/OIS and FX Swaps), interest rate risk hedging transactions (derivatives). The Bank's policy with regard to banking book is to exercise additional income above the product margin, without compromising excessively stability of deposits placed by the clients, of Bank's capital and its results; through retaining or adjustment – within approved risk limits – of Bank's natural risk profile in order to benefit from expected mid- and long term financial market trends.

Trading book has a supplementary character, supporting sale of financial market products to corporates (directly) and retail (indirectly, in structured products). By opening own positions to facilitate above needs, Bank is able to generate additional income from short-term change in market parameters (foreign exchange rates, interest rates, quoted prices of debt instruments, etc), staying within approved risk limits. Trading book also includes Bank's total on- and off-balance foreign exchange position. In accordance with approved risk policy, Bank BGŻ is not involved in credit risk trading (e.g. CDS, ABS and corporate debt rated below Poland credit rating) nor does run non-linear positions in options.

Organization of risk management process

Supervisory Board approves financial risk appetite, Management Board, following Bank's long term strategy and financial plan, establishes accepted risk profile, in line with risk appetite, distributing available capital to business lines that further, in a form of risk limits, is assigned to different books by Balance Sheet and Risk Management Committee (BRMC), acting on behalf and under authorization of the Board.

Operational management of trading book is under Financial Markets Department, which also manages Money Market portfolio (banking book). Remaining part of the banking book (ALM portfolio) is the Assets and Liabilities Management Bureau's responsibility. Risk measurement, reporting and limit breach monitoring, independent valuation and management P&L calculation, booking and processing of the deals is performed by independent units, under supervision of Board members responsible for Finance, Systemic Risk, Financial Markets, IT and Operations Areas. Acceptance of limit breaches is also organized in hierarchical way: depending on type of limit (its "importance") and size of the excess (technical, minor, major) the acceptance is given on a levels from director or risk reporting unit to the Board member supervising Systemic Risk Area, final acceptance is BRMC competence.

Scope and types of risk reporting and measuring systems

Main risk measures, used to assess risks in banking book, are interest rate gaps: repricing gap and sensitivity gap, indicating respective size and distribution of mismatches of repricing/maturity dates and sensitivities of assets, liabilities and off-balance positions to interest rate changes. Based on this information, the Bank's analysing and limiting: sensitivity of Bank's interest income (Interest at Risk) to yield curve's shifts and sensitivity of present value of Bank's net equity (Equity at Risk) to parallel shifts of the yield curves. Risk monitoring takes also into consideration other parameters, such as types of allowed instruments/transactions, currencies, maximum maturities and minimum rating for debt securities for specified parts of banking book.

Separate monitoring is conducted to verify risk levels expressed in terms of Value at Risk in Money Market portfolio, amended by the stress tests programme, comprising scenarios exceeding statistically expected volatility of the market. Dedicated stress tests to identify and quantify basis risk in banking book are carried out.

Funds transfer system, being a main source of information on risk profile generated by the Bank's core credit & deposit activity in the branches, is based on the replication mechanism, working on a daily basis at the level of a single transaction. In case of market-benchmark-based products (e.g. WIBOR, LIBOR loans) or fixed rate products, risk profile is directly available from repricing schedule or maturity date. For products with unspecified maturity/repricing profile (current accounts, overdrafts), products where the price changes arbitrarily (e.g. by the Board decision), products which price is indirectly correlated with observed market rates (e.g. average market rates, NBP rediscount rate), as well as for overdue loans the Bank uses replicating portfolios, trying to reflect the actual risk profile. In such cases, the exposure is being split into floating part, which usually is being assigned an O/N repricing, and core (“sticky”) part, which structure and maturity can differ from product to product, e.g. for current accounts it is 12 yearly deposits, maturing and rolling over consecutively every month. Remaining products are usually being assigned 1M repricing cycle, what reflects their correlation with changes of interest rates by the Monetary Policy Council, or spread in time in line with the actual distribution of repricings.

Value at Risk (VaR) is a main risk measure in trading book and in Money Market portfolio. The Bank is using parametric method with exponential weighting, kurtosis adjustment, 99% confidence interval and 1-day holding period (1 month in Money Market portfolio). The VaR is limited both with respect to end of day position as well as to intraday position. Additional risk limits comprise sensitivity limits (delta/BPV), open position limits, stop-loss limits as well as stress-tests’ implied loss limits, basing on theoretical as well as historical scenarios. Further constrains include maximum maturity of transactions, allowed instruments as well as currencies.

Current reporting on market risk in trading and banking books is prepared daily and distributed to employees directly managing the positions, to their supervisors and to Board members. Periodical reports: monthly, quarterly and annually (for BRMC, Management Board and Supervisory Board) present analysis and explanation for the changes that took place, split in different risk types, books / portfolios, currencies etc., as well as specify recommendations and suggestions as to the steps to be taken in order to improve risk profile.

B3. COUNTRY AND COUNTERPARTY RISK

Counterparty credit risk and country risk are understood as risks of the Bank incurring loss as a result of default or increased likelihood of default on whole or part of payments expected from the counterparty, coming from worsening of its financial situation, substantial adverse change in market or economic environment or limitations resulting from deterioration of economic or political situation, or changes in legal system of the country of their residence.

Counterparty risk discussed here concerns financial market transactions: interbank deposits, purchase and sale of debt securities, spot foreign deals as well as derivatives.

Risk management strategies and processes

Bank’s policy with regard to country and counterparty risk is to minimize the likelihood of situation, where substantial loss is generated as a result on default on full or partial payment of expected from single or group of connected counterparties.

With regard to financial counterparties, Bank’s policy is to concentrate on cooperation with institutions with at least investment grade rating as well as to diversify total exposure with respect to clients and countries. In terms of corporate counterparts, the Bank only supports their needs with regard to transactions hedging their market risk profile generated from core business; and precedes granting of the limit with full and thorough analysis of credit and market risk profile of the client.

Country and counterparty risk is controlled with the system of exposure limits, established for all Bank's counterparts – each transaction uses the counterparty limit and in case he's not a resident, also a country limit.

Organization of risk management process

Counterparty risk assessment process is separated from operational duties, trading deals in particular – design of structure and size of particular exposure limits towards financial counterparties (banks, insurers, investment and pension funds, etc) and countries, as well as periodical monitoring and review of already existing limits are within the scope of responsibilities of unit supervised by Board member responsible for Systemic Risk , however final approval of the limits is with BRMC. Size of the limit is established based on methodologies developed internally for individually homogenous groups of clients, that take into account financial situation (dynamic and structure of results, liquidity), size of capital available to cover for risk, external credit ratings, ownership structure and – if available – history of cooperation. With regard to countries, specific additional factors include assessment of economic and political stability. In this process Bank BGŻ is following recommendations from and considers risk profile accepted by majority shareholder.

In case of non-financial counterparties, process of establishment of transactional limit is a part of credit process, i.e. it is based on assessment of financial standing of the client, recognition of specifics of its operations (e.g. amounts, currencies and schedule of payments, likelihood of payments actually happening, hedging transactions made with other banks, etc) and in consequence fitting of financial market instruments to client's risk profile, in order to mitigate identified risks and stabilize the results. Bank BGŻ excludes possibility of intentional speculative transactions, even if the cooperation is based under cash collateral. Final sizing of the limit, specification of non-monetary constrains (types of allowed transactions, allowed currencies, max maturities, etc), establishment of conditions needed to be met before the limit can be made available as well as decision on the list of applicable collaterals is within scope of responsibility of Credit Committee of 1st of 2nd degree in Bank's headquarter and Credit Committees in Regional Branches.

Scope and types of risk reporting and measuring systems

As a main tool to mitigate counterparty risk Bank's using exposure limits: presettlement and settlement limits. Presettlement limit controls the size of credit exposure during the life of transactions: in Bank BGŻ it is composed of current NPV of the transaction and risk add-on, reflecting the expected, statistically justified adverse change of that NPV until the maturity date of the deal. Settlement limit is used to reduce concentration of cash flows due from the counterparties on a single date (at reporting date and in all future dates) and is utilized by all expected cash flows, taking into account specific settlement mechanisms of various instruments (i.e. cash settlement vs. delivery).

In case of financial institutions Bank BGŻ specifies a catalogue of available instruments, including additional limit on transactions that engage Bank's actual funding (e.g. interbank deposits, purchase of debt securities issued by the counterparty); and in case of non-financial clients limits allowed currencies/pairs, max maturities, possibility to roll over on historical prices, max open FX position. Limits are being established for maximum 12 months, but even during that time financial situation of the counterparty is under monitoring.

Utilization of available limits as well as overview of remaining constraints is available on-line in the front office system for Bank's employees authorized to deal transactions with financial and non-financial clients. Independent verification of limits' utilization and adherence to non-monetary restrictions (allowed instruments, currencies, maturities, etc.) is carried out by independent unit under supervision of Board member responsible for Systemic Risk Area, that reports daily on the size and structure of exposures in various analytical dimensions to the dealers, to their supervisors and to Board members; as well as requests explanation and acceptance – according to approved authority hierarchy – of limit breaches. In case of non-financial counterparties the unit also prepares information of client's advisors in branches, regions and corporate centers, in order to allow them to agree hedging or collateralization strategy with the client once the exposure gets close to the limit, limit expired or was closed.

Monthly reports summarizing Bank's activity, size and structure of exposure are being prepared for BRMC; quarterly information for Management Board and Supervisory Board.

B4. OPERATIONAL RISK

Strategies and processes in operational risk management

The Bank manages the operational risk based on the approved strategy and policy.

Operational risk is defined by the Bank as the possibility to incur losses or an unjustified cost resulting from inadequate or failed internal processes, people and systems or from external events. Legal risk and compliance risk (partly including legal risk) are included into the operational risk. Compliance risk is the risk of occurrence of legal sanctions, financial losses or damage in the Bank's reputation as a result of the non-compliance of the Bank's business with the commonly binding laws and the Bank's internal regulations, including the best practice standards. The compliance risk shall be also generated by the inconsistency of the Bank's internal regulations and the regulations inside the capital group, faulty agreements and change in the laws or the interpretation thereof. Strategic risk is excluded from the operational risk.

The objective of the operational risk management is to ensure the top quality standards of services rendered by the Bank, to ensure their security and compliance with the binding regulations and the best standards and lowering the losses and costs caused by the operational risk at the same time. Organizational culture in operational risk management plays an important role for the Bank. Key element is employees' awareness about the risk and their share in the responsibility for its reduction. Operational risk is commonly present in the banking activity, what means that each of the employees and each of the organizational units are responsible for operational risk identification within their scope of responsibilities and taking actions aimed at risk reduction.

Operational risk management system is integrated. It means that all actions and functions concerning operational risk management are combined in one, consistent, transparent, complete and efficient system. In order to avoid a potential conflict of interests and in order to ensure objectivity, operational risk assessment function in the Bank is separated from the function responsible for making business decisions. Operational risk control function is autonomous and placed in Systemic Risk Area.

Operational risk management process included the following stages:

a. risk identification,

b. defining risk causes (sources),
c. assessment of the risk amount and setting its acceptable level,
d. analysis of possible solutions to reduce the identified risk,
e. taking a decision to reduce risk,
f. taking necessary actions,
g. control and assessment of applied risk reduction tools (feedback).

Organization of the operational risk management process

Operational risk management is carried out in an integrated form, within the dedicated operational risk management structure, that is separated both in organizational and functional form. It includes:

a. Operational Risk, Compliance and Antifraud Subcommittee acting as part of the Balance Sheet and Risk Management Committee – responsible for supervision, coordination of the processes and allocation of tasks and resources within the operational risk management system,

b. dedicated unit in the Head Office of the Bank – responsible for development, coordination and control of the basic operational risk management processes, as well as development and implementation of tools, procedures and operational risk management rules,

c. operational risk management positions in Regions – responsible for operational risk management in Regions.

Operational risk management is closely connected to the management of other kinds of risk due to the fact that a substantial part of the operational risk losses occur between operational risk and credit risk or operational risk and financial risk, as well as other banking risks.

Actions directly aimed at operational risk mitigation are taken by units responsible for individual areas exposed to operational risk (first line of responsibility).

Scope and types of risk reporting and measuring systems

One of the operational risk management stages is taking actions aimed at risk reduction. Those actions mean preventing the threat or reducing the consequences of the event as well as carrying out system actions aimed at elimination of causes of the events. Systems actions are e.g. eliminating the gaps in internal regulations and procedures, preparing new or changing the existing tools, introducing changes to work organization, improving control mechanisms and introducing changes to IT systems. Before taking such actions, their costs are analyzed as well as potential losses that can be borne without implementing the suggested solution.

For the operational risk monitoring and assessment the Bank applies among others: the self-assessment method, Key Operational Risk Indicators (KRI) as well as the data about identified operational risk events and threats, incl. operational risk losses. The Bank decides on its risk tolerance (operational risk appetite) and takes appropriate actions when the accepted risk level is exceeded.

The Bank's Management is regularly informed about the level of operational risk as well as about actions taken due to identified operational risk events and threats.

The Bank applies insurances within the framework of risk transfer.

C. OWN FUNDS

Own funds increased by PLN 368 206 thousand, which was the result of the following factors:

- inclusion to supplementary funds of subordinated liability in the amount of CHF 90 000 thousand. CHF (304 344 thousand. PLN as at 31 December 2013) to a strategic shareholder, with the consent of the Polish Financial Supervision Authority issued in August 2013;
- retention of net profit for 2012 in the amount of PLN 134 343 thousand, which increased the capital reserve;
- higher by PLN 43 706 thousand profit in the course of approval, which is the net profit for the first half of the year after a review of interim financial statements by an auditor;
- increase in unrealized losses/decrease in unrealized profits on debt securities classified as available for sale and recognized respectively in basic /supplementary funds of the Bank – in total by PLN 115 651 thousand. The mechanism of this decrease has been described in the paragraph devoted to the total income of the Bank.

The decrease of the capital requirement for credit risk by PLN 44 487 thousand y/y corresponded to the inhibition of lending. The increase in the capital requirement for operational risk corresponded to the increase in the result being a basis for the calculation of this requirement in accordance with BIA method used by the Bank (the requirement is calculated as 15% of the average result for the previous three years).

Tab. Own funds and short term capital - 31.12.2013 in PLN thou.

type of funds	PLN thou.
principal funds	**3 340 115**
share capital	51 137
other supplementary capital	3 085 059
other reserve capital	25 000
undividable profit from previous years	6 387
general risk fund	90 000
net profit under authorization in the amount verified by the external auditors	82 532
deductions from the principal funds	**-196 550**
intangible assets	-158 589
unrealized losses on equity instruments classified as available for sale	-
unrealized losses on debt instruments classified as available for sale	-20 435
equity investments in financial institutions	-17 526
supplementary funds	**404 305**
unrealized gains on debt securities classified as available for sale	98 858
unrealized gains on equity instruments classified as available for sale	1 103
subordinated liabilities	304 344
deductions from the supplementary funds	**-17 526**
equity investments in financial institutions	-17 526
short term funds	**14 774**
total own funds	**3 545 118**

Bank's share capital as on the 31st of December 2013 amounted to PLN 51,137 thousand. The nominal value of each share is PLN 1.00, out of which:

- 45,942,004 belong to Rabobank International Holding B.V.,
- 4,303,695 belong to Cooperatieve Centrale Raiffeisen–Boerenleenbank B.A.
- 891,065 belong to other shareholders.

As at 31 December 2013 and 31 December 2012 none of the members of Management Board or Supervisory Board held the Bank's shares directly.

Statutory reserve capital consists of distributions made from the net profit for the year or from other sources. Statutory reserve capital is allocated to absorb the Bank's accounting losses or for other purposes, including distribution in the form of dividends to shareholders. The Annual General Meeting decides on the appropriation of the statutory reserve capital.

Other reserves is a special fund for unidentified risks from all or part of the general banking risk reserve. This reserve can only be used to absorb the Bank's accounting losses. Other reserves include a reserve, which is created as the result of the revaluation of financial assets available for sale.

The general banking risk reserve was established in accordance with the Banking Act dated on the 29th of August 1997 from the net profit for the year. The general banking risk reserve can be appropriated only with the approval of the shareholders at the General Shareholders Meeting of the Bank.

Short-term capital includes market revenue as specified in the article 5 point 1 of the Resolution No. 76/2010 of the Financial Supervisory Commission of the 10th of March 2010 with further changes and is calculated increasingly to the report date, reduced with liabilities, including dividends, within the scope that was not included in the Bank's own funds or allocated in any another way.

D. ADHERENCE TO THE CAPITAL REQUIREMENTS

D1. CAPITAL ADEQUACY ASSESSMENT METHOD

In 2013 Bank BGŻ calculated regulatory capital requirements in line with the Resolution No. 76/2010 by the Financial Supervisory Commission of the 10th of March 2010 on the scope and detailed procedures for determining capital requirements for particular risks (with subsequent changes). As far as the credit risk is concerned, the Bank made use of the standardized approach. In case of operational risk the basic indicator approach was used, and for market risk the standardized methods in line with Basel II were implemented.

Within the process of regulator capital requirement calculation the Bank made use of the credit ratings assigned by Fitch Ratings and Moody's Investors Services. The Bank did not include ratings by Standard & Poor's and export credit insurance companies. All the ratings used by the bank were implemented in the process of the regulatory capital requirement calculation for credit risk of exposures to governments and central banks, to institutions and to companies.

In order to reduce the regulatory capital requirements, the Bank made use of credit risk mitigation techniques, including: a) collaterals - the reduction in credit risk results from the rights to liquidate, transfer, take over or keep specified assets or amounts in case of a client's default; b) guarantees – the reduction in credit risk results from a third party's commitment to repay a specified amount in case of a client's default or other specified credit events. With respect to credit risk mitigation techniques 53% of overall protection is provided by one credit institution.

D2. REGULATORY CAPITAL REQUIREMENTS AND CAPITAL ADEQUACY RATIO

Regulatory capital requirements

The following tables present regulatory capital requirements per risk types as well as the division of regulatory capital requirements for credit risk per category of an exposure.

Tab. Consolidated regulatory capital requirements – 31.12.2013 in PLN thou.

	PLN thousand
credit risk, settlement risk & counterparty credit risk	1 942 844
market risk including:	7 604
FX risk	-
commodity risk	-
price risk of equities	-
specific risk of debt instruments	-
general interest rate risk	7 604
exceeding of the limit of exposure concentration and the limit of big exposures	-
exceeding of capital concentration's threshold	-
operational risk (BIA)	187 120
total	**2 137 569**

Tab. Capital requirements for credit risk – 31.12.2013 in PLN thou.

category	PLN thousand
claims on sovereigns	-
claims on local authorities	4 100
claims on non-central government public sector entities (PSEs)	4 016
claims on multilateral development banks (MDBs)	-
claims on international organizations	-
claims on institutions	24 169
claims on corporates	312 019
claims included in the regulatory retail portfolios	318 435
claims secured by realestate mortgage	1 165 018
past due loans	52 980
higher-risk categories	3 235
secured bonds	-
short term exposures to banks and corporates	-
investments units	-
other	58 873
total	**1 942 844**

Capital adequacy ratio

The capital adequacy ratio increased from 11.79% at the end of 2012 to 13.27% at the end of 2013.

D3. RISK MITIGATION TECHNIQUES

Policy and procedures for netting on-balance and off-balance sheet

Bank BGŻ does not use compensation of on- and off- balance exposures in normal operational activities and therefore does not take such effects into account while calculating its regulatory capital requirements.

However, the Bank takes into account that framework agreements signed with particular clients (see the part "H. Counterparty credit risk") allow for compensation of mutual liabilities in case of early termination and settlement of transactions, if the client breaks the agreement or his financial situation deteriorates significantly. Therefore the Bank includes this netting effect while calculating the size of exposure to manage its counterparty credit risk, as well as while estimating its economic capital and adjusting fair value.

Policy and procedures for collateral valuation and collateral management

Credit risk management policy and other Bank's internal regulations determine requirements concerning principles of assessment of entities that establish personal collaterals and general rules for material collaterals' valuation.

The acceptance of personal collateral has to be preceded by the assessment of credibility and financial standing of collateral issuer. In case of material collateral, e.g. register pledge and transfer of ownership, the assessment of current market value of collateral is required.

In case of mortgage-backed transactions, Bank BGŻ determines market value of real estate at the basis of professional appraiser valuation, subject to selected types of real properties (agricultural land) when the Bank accepts internal valuations basing on statistics and transactional prices.

The update of collateral value is an element of monitoring.

Types of credit collaterals, guarantors and counterparties within credit derivatives

According to the art. 93 of the Banking Law, to secure bank's receivables a bank may request a client to establish collateral which is governed by the rules of Civil Code, law on bills of exchange or customs being in force in domestic or international market. Following the general statement of the Banking Law, Bank BGŻ accepts personal collaterals where the whole property of a debtor titled from collateral may be used to meet Bank's claims and material collaterals - where Bank's claims may be realized from property being the subject of collateral agreement. In the Bank civil guarantee is the most often used collateral out of the catalogue of personal collaterals. As far as the catalogue of material collaterals is concerned, the most often used collaterals by the Bank are: register pledge, mortgage and transfer of ownership.

Tab. Exposures protected with recognized collaterals and guarantees – 31.12.2013 in PLN thou.

exposure class	PLN thou.
claims on sovereigns	-
claims on local authorities	-
claims on non-central government public sector entities (PSEs)	951
claims on multilateral development banks (MDBs)	-
claims on international organizations	-
claims on institutions	-
claims on corporates	91 971
claims included in the regulatory retail portfolios	76 653
claims secured by realestate mortgage	58 914
past due loans	3 808
higher-risk categories	-
secured bonds	-
short term exposures to banks and corporates	-
investments units	-
other	-
total	**232 297**

Tab. Exposures protected with guarantees defined under New Basel Capital Accord – 31.12.2013 in PLN thou.

exposure class	PLN thou.
claims on sovereigns	-
claims on local authorities	-
claims on non-central government public sector entities (PSEs)	657
claims on multilateral development banks (MDBs)	-
claims on international organizations	-
claims on institutions	-
claims on corporates	67 121
claims included in the regulatory retail portfolios	47 950
claims secured by realestate mortgage	43 000
past due loans	3 669
higher-risk categories	-
secured bonds	-
short term exposures to banks and corporates	-
investments units	-
other	-
total	**162 397**

The Bank does not use credit derivatives. As far as guarantees are concerned, the main guarantors are: Rabobank Nederland (with AA rating), as well as unrated Polish banks.

E. INTERNAL CAPITAL REQUIREMENTS – ECONOMIC CAPITAL

Bank BGŻ defines internal capital as the value of capital that should be kept by the Bank to cover losses with such a value, that the probability of incurring them within 12 months is lower than 0.1%. The total value of internal capital consists of capital for the following risk types:

- credit risk,
- country and transfer risk,
- concentration risk,
- market risk (incl. market risk in the trading portfolio and the interest rate risk in the banking book);
- operational risk,
- business risk,
- significant immeasurable risks.

Internal capital for the business risk is calculated on a yearly basis. Internal capital for all other risk types is calculated monthly. Bank BGŻ treats internal capital as one of the Bank's management tools allowing for defining risk limits and estimation of Bank's effectiveness. The Bank has implemented internal tools allowing for estimation of risk adjusted return on (internal) capital (i.e. RAROC). The table below presents the structure of internal (economic) capital at the end of 2013.

Tab. Economic capital structure – 31.12.2013 in PLN thou.

risk type	PLN thou.	share
credit risk	1 545 364	72,70%
concentration risk	19 374	0,91%
country and counterparty risk	9 082	0,43%
operational risk	196 256	9,23%
market risk	73 462	3,46%
other asset related risks	31 412	1,48%
buisness risk	250 600	11,79%
total	**2 125 550**	**100,00%**

Brief information on internal capital model for credit risk, country and transfer risk as well as concentration risk

For the purpose of internal capital calculation for credit risk the Bank distinguishes models for non-financial as well as for financial obligors.

Internal capital calculation for non-financial obligors is performed in Bank BGŻ with the use of methods originating from the AIRB approach. Each credit exposure is assigned a score, a rating or a risk class which is dependent on different characteristics of the exposure. Furthermore, for each score, rating , as well as a risk class a probability of default is applied. A level of the probability of default combined with information of a client's segment and specificity of client's activity influence the correlation coefficients. The correlation coefficients represent the level of dependence of a client's economic and financial situation on macroeconomic factors (systematic factor). Loss given default coefficients (LGD) are assigned to all credit exposures depending on the characteristics of: a facility, a client's segment and collaterals.

The Bank has comparatively large exposures to some of its clients. Therefore additional economic capital has to be calculated to cover the concentration risk. A model designed to cope with the task is based on the Monte Carlo simulation. It assumes that the additional capital requirement is obtained through comparison of loss distributions for: a) an ideally granulated portfolio, b) an existing credit portfolio. The capital requirements for the credit risk as well as for the concentration risk are calculated monthly. The assumed confidence level is 99.9%.

Internal capital calculation for banks, countries and all exposures resulting from derivatives is performed with the use of a separate model originating from the AIRB method, too. In this case, the starting point for the calculation is a set of internal or external ratings. As far as the loss given default (LGD) parameter is concerned, IRB Foundation assumptions from New Basel Capital Accord are used. Similarly as in the case of credit risk of non-financial obligors, a yearly risk-taking horizon and a confidence level of 99.9% are assumed. The capital is calculated on a monthly basis.

Brief description of the internal capital models for the market risk

Economic capital for the market risk is calculated as a sum of:

- Interest Income at Risk worse scenario(out of 5 scenarios assuming yield curves 1-year changes) - for the ALM portfolio (banking book);
- Value at Risk (VaR), based on parametric delta-normal model (Bank does not allow for open positions in options – all corporate transactions are immediately closed on a back-to-back principle) with and adjustment for kurtosis observed in empirical distribution of changes in risk factors, with no exponentially weighting, according to the attachment No. 19 to the Resolution No. 76/2010 by the Financial Supervisory Commission – for Trading Book and Money Market portfolio in banking book.

  Important assumptions:
- Diversification of risk factors is taken into account when calculating economic capital only for summarized expositions from Trading and Money Market portfolio (VaR), whereas it is not taken into account in case of VaR and IaR total;
- VaR (holding period: 1Y) is based on Foreign Exchange (FX) and Interest Rate (IR) risk factors, and it does not take into account: commodity risk and equities price risk, as those kinds of exposures are closed back-to-back or non-existent in the Bank respectively.

Calculation of internal capital for market risk, including also interest rate risk in banking book, is performed on a monthly basis.

Brief description of the internal capital model for the operational risk

For calculation of the internal capital for operational risk, the Bank applies the method commonly used in insurance and by other banks as a standard for operational risk assessment as well as for calculation of the regulatory capital requirements under the Advanced Measurement Approach (AMA). This method is based on a separate analysis of the probability distribution of the number of operational risk events, which occurred in the assumed time period, as well as on analysis of loss severity distribution for the individual event that happened. Both distributions are combined then, and it leads to obtaining a distribution of the probability of annual loss and to estimating the internal capital. When estimating the amount of this capital, the Bank's internal data is used as well as the results of scenario analysis performed by the Bank's operational risk management experts. As a target solution the Bank is also going to include in the analysis data from external databases provided by other institutions. Similar to other risks mentioned above, a one year horizon of losses and the confidence level of 99.9% are assumed.

F. IMPAIRMENT OF FINANCIAL ASSETS

The following chapter presents only the values of assets that are tested for impairment under International Accounting Standards (IAS39), which differs from values in Financial Statement where all assets are presented. Impairment assessment of financial assets in line with the International Accounting Standards (IAS 39) is performed for such assets that are valued in line with amortized cost. Those assets include:

a. credits and loans,

b. debt securities classified as held till maturity

c. off-balance sheet commitments resulting from guarantees, letters of credit, unused credit limits, with the exception for those off-balance sheet commitments that result from derivatives.

The impairment assessment concerns also unlisted capital instruments and capital commitments classified as "available for sale" for which the loss is directly reflected in own funds and there is objective evidence for impairment of such an asset. Furthermore, the impairment assessment is not performed for derivatives that are priced in line with the fair value method.

Bank BGŻ performs monthly calculation of impairment of financial assets. The calculations are performed according to IAS 39 with the use of an IT application. An initial point for the calculation is an assignment of impairment evidences to exposures. Generally following situations are considered as an impairment evidence:

a. a delay or lack of principal, interests or other payments resulting from credit agreement; the delay must be longer than 90 days;

a. preferential treatment of a client as a consequence of economic or legal reason due to financial difficulties of a client, while the preferential treatment would not be accepted in other circumstances[1],

b. disadvantageous changes in financial and economic standing of the client[2],

[1] Including loan restructuring which generates economic loss for the Bank.

c. termination of a loan agreement by the Bank,

d. bankruptcy, liquidation or beginning of the liquidation process of the client,

e. statement made by a client on initiated remedial proceedings;

f. initiated execution against a client,

g. disadvantageous changes in scoring or rating analysis,

h. lack of active market for a credit exposure due to financial difficulties,

i. contest of a credit exposure by a client through legal proceedings.

When the impairment's evidence is recognized for an individually significant asset, a Bank's employee responsible for the exposure estimates the value of the future cash flows that, after discounting, represent current value of the exposure and allows for calculation of impairment of the asset. Individually significant financial assets for which impairment was not recognized, as well as all individually insignificant financial assets are assessed on a collective basis. Within collective approach the value of impairment provision for exposures with recognized impairment evidence is calculated. The collective approach covers also the calculation of IBNR provision (incurred but not reported losses) for those exposures that were not recognized as impaired.

Tab. Exposures per impairment assessment method – 31.12.2013 in PLN thou.

assessment method	number of exposures	average exposure value	gross exposure value		impairment provision	nett exposure value	
individual - impaired exposures	857	1 544	1 323 012	4,1%	512 544	810 467	2,6%
collective - impaired exposures	26 497	37	984 381	3,1%	616 985	367 396	1,2%
collective - not impaired exposures	372 389	80	29 829 753	92,8%	105 362	29 724 391	96,2%
total	**399 743**	**80**	**32 137 145**	**100,0%**	**1 234 891**	**30 902 254**	**100,0%**

The exposure is understood as a sum of on-balance and off-balance sheet exposure.

[2] E.g. it can be recognized through analysis of a financial statement (or other documents provided by a client) or it can results from getting information on loss of job, income decrease, debt increase or missed payments in other institutions.

Tab. Exposures and impairment provisions per economy sector – 31.12.2013 in PLN thou.

industry	exposure					impaiment provisions		
	non impaired		impaired		total	non impaired	impaired	total
agriculture	9 390 642	97,2%	275 362	2,8%	9 666 004	19 834	131 778	151 612
wholesale trade	2 413 624	88,9%	300 835	11,1%	2 714 458	12 726	142 175	154 901
manufacture of food products	2 594 997	93,0%	195 234	7,0%	2 790 230	8 163	87 509	95 672
construction	416 241	60,5%	272 125	39,5%	688 366	3 799	103 303	107 103
manufacture of chemical prod.	666 231	97,6%	16 434	2,4%	682 665	2 281	8 021	10 302
retail trade	603 585	88,1%	81 620	11,9%	685 205	4 502	44 164	48 667
real estate activities	382 724	92,6%	30 752	7,4%	413 477	2 534	6 035	8 568
manufacture of metals and minerals	454 850	82,8%	94 634	17,2%	549 484	2 039	45 339	47 378
professional, scientific and technical activities	428 006	79,9%	107 681	20,1%	535 687	1 589	90 884	92 473
manufacture of wood and paper products	348 453	83,1%	70 765	16,9%	419 218	1 886	37 628	39 514
electricity, gas, steam and air conditioning supply	364 736	96,7%	12 433	3,3%	377 169	1 614	2 897	4 511
transportation and storage	394 544	92,7%	31 238	7,3%	425 782	2 215	17 840	20 055
other business	320 756	95,8%	13 950	4,2%	334 706	503	2 993	3 495
manufacture of machinery, equipment and vehicle	436 843	94,6%	24 925	5,4%	461 768	2 558	10 763	13 321
hotels and restaurants	209 879	83,6%	41 032	16,4%	250 911	2 040	11 033	13 074
information and communication	138 992	95,6%	6 359	4,4%	145 351	352	4 125	4 477
manufacture of textile, leather	83 451	75,4%	27 178	24,6%	110 629	826	15 380	16 206
health care & social help	128 375	99,0%	1 252	1,0%	129 627	918	595	1 513
other industries	575 078	87,4%	83 152	12,6%	658 231	2 480	26 504	28 984
private persons	9 477 747	93,9%	620 431	6,1%	10 098 177	32 504	340 561	373 065
total	**29 829 753**	**92,8%**	**2 307 392**	**7,2%**	**32 137 145**	**105 362**	**1 129 529**	**1 234 891**

The exposure is understood as a sum of on-balance and off-balance sheet exposure.

Tab. Exposures and impairment provisions per residual maturity class – 31.12.2013 in PLN thou.

residual maturity	exposures					impairment provisions for exposures		
	not impaired		impaired		total	not impaired	impaired	total
up to 1 year	5 543 457	85,0%	976 457	15,0%	6 519 914	25 163	608 683	633 846
from 1 to 3 years	3 035 540	92,1%	258 866	7,9%	3 294 406	10 202	116 326	126 528
from 3 to 5 years	3 451 449	93,8%	227 645	6,2%	3 679 094	11 981	49 545	61 526
from 5 to 10 years	5 122 066	94,4%	305 797	5,6%	5 427 863	20 957	120 546	141 502
over 10 years	12 171 645	96,2%	485 003	3,8%	12 656 649	35 655	207 866	243 521
unspecified	505 596	90,4%	53 624	9,6%	559 219	1 404	26 563	27 967
total	**29 829 753**	**92,8%**	**2 307 392**	**7,2%**	**32 137 145**	**105 362**	**1 129 529**	**1 234 891**

The exposure is understood as a sum of on-balance and off-balance sheet exposure.

Tab. Exposures and impairment provisions per region – 31.12.2013 in PLN thou.

region	exposures					impairment provision for exposures		
	not impaired		impaired		total	not impaired	impaired	total
Head Office	122 796	13,6%	782 373	86,4%	905 169	169	489 573	489 743
Central	3 631 473	91,6%	332 530	8,4%	3 964 002	11 551	85 109	96 660
Central-Western	4 540 287	94,5%	265 139	5,5%	4 805 426	14 681	148 613	163 295
South-Eastern	3 083 544	95,3%	152 062	4,7%	3 235 606	15 000	71 509	86 509
South-Western	2 592 476	95,7%	116 792	4,3%	2 709 268	9 322	42 183	51 506
Southern	2 162 876	94,0%	137 317	6,0%	2 300 192	8 522	66 216	74 738
North-Eastern	3 078 470	98,1%	59 093	1,9%	3 137 563	10 171	26 644	36 814
North-Western	2 056 595	96,4%	76 960	3,6%	2 133 555	6 654	35 023	41 677
Northern	5 341 426	94,5%	310 663	5,5%	5 652 089	18 441	126 023	144 464
Eastern	3 219 811	97,7%	74 464	2,3%	3 294 276	10 850	38 636	49 485
total	**29 829 753**	**92,8%**	**2 307 392**	**7,2%**	**32 137 145**	**105 362**	**1 129 529**	**1 234 891**

Remark: The exposure is understood as a sum of on-balance and off-balance sheet exposure; the regional structure is in line with the Bank's structure.

Tab. Changes in impairment provisions in 2013 in PLN thou.

PLN thou.	current account loans	loans and advances	banks	corporate customers	households	public sector institutions	other entities	off-balance sheet exposures	total
impairment allowances at the beginning of the period	**147 457**	**923 491**	**1 012**	**389 681**	**525 371**	**445**	**6 982**	**7 257**	**1 078 205**
allowance recognised	230 350	1 202 448	135	577 527	623 737	373	676	34 293	1 467 091
allowance reversed	-193 175	-1 002 272	-172	-470 591	-530 383	-558	-568	-22 994	-1 218 441
write-off	-8 135	-88 716	-408	-37 798	-50 476	-	-34		-96 851
other changes (exchange differences)	45	5 060	17	-9 143	14 186	-	-	-218	4 887
impairment allowances at the end of the period	**176 542**	**1 040 011**	**584**	**449 676**	**582 435**	**260**	**7 056**	**18 338**	**1 234 891**

G. MARKET RISK

The Bank's product policy, i.e. using of floating rates for credits, financed by short term fixed rate deposits results in a well matched interest rate exposure, concentrated in short tenors: as at end of 2013 90% of balance positions reprices or matures within 6 months, 79% within 3 months, and 53% within one month. Derivatives were used to hedge interest rate risk of state treasury debt securities portfolio as well as a source of liquidity to finance foreign currency denominated portfolio of retail mortgage loans (to a limited extent). The table on next page presents key risk measures for banking book as end of 2012 and 2013.

Tab. Banking book risk profile in PLN thousand

risk measure	31.12.2012	31.12.2013	change	change [%]
Repricing gap (marginal)				
up to 1M	7 565 145	4 591 236	-2 973 909	-39%
1-3M	-1 962 019	-168 620	1 793 399	91%
3-6M	-709 530	2 115 495	2 825 024	398%
6-24M	-2 829 293	-3 994 792	-1 165 499	-41%
over 2Y	732 074	681 391	-50 683	-7%
Interest at Risk 1)	-1 334	14 128	15 461	1159%
PLN impact	-6 886	11 269	18 155	264%
EUR impact	2 902	2 646	-256	-9%
USD impact	-592	-459	133	23%
other currencies	3 243	672	-2 571	-79%
Equity ar Risk (up) 2)	-30 236	-47 177	-16 941	-56%
Equity ar Risk (down) 2)	54 452	67 867	13 415	25%

1) Sensitivity of 12-month interest income to 50bps interest rate movement.
2) Sensitivity of net equity's fair value to 200 bps interest rate movement.

In 2013 Bank BGŻ continued its conservative policy with regard to market risk in trading book, concentrating its efforts on support of sale of treasury products as well as on investing of surplus liquidity. Foreign exchange position was closed by the end of the day, Bank did not run option book (all client options were closed back-to-back) and did not engaged into credit derivatives and corporate debt.

Money Market portfolio consisted mainly of short-term debt instruments held as liquid assets, interbank deposits, FX Swap transactions (short-term foreign currencies funding, clients FX Forward decomposed IR positions hedging), and OIS/IRS transactions (debt instruments risk hedging, funding cost stabilization, portfolio's risk profile modification).

The table below presents key risk measures for trading book and Money Market portfolio as end of 2012 and 2013.

Tab. Trading book and Money Market risk profile in PLN thousand

risk measure	31.12.2012	31.12.2013	change	change (%)
Trading book:				
Value at Risk (99%, 1D holding period)	589	325	-264	-45%
FX risk	14	23	9	67%
IR risk	586	325	-260	-44%
overall FX position	-900	-4 275	-3 376	375%
the most harmful stress test	8 222	1 805	-6 417	-78%
Money Market portfolio:				
Value at Risk (99%, 1M holding period)	6 687	1 897	-4 790	-72%
the most harmful stress test	16 841	15 604	-1 237	-7%

H. COUNTERPARTY CREDIT RISK

In addition to conservative credit risk policy, pertaining to establishment of safe size of transactional exposure limits towards the counterparties, Bank BGŻ puts emphasis also on the quality of legal framework, under which the transactions are being made.

Bank BGŻ aims to cooperate with all financial clients under ISDA agreements annexed with CSA (Credit Support Annex) that enables netting of undue exposures as well as is setting a maximum accepted exposure level (threshold), above which the side of the agreement for which the valuation of transactions is negative is obliged to provide additional collateral (margin call). As at end of 2013, Bank BGŻ had signed ISDA agreements with approx. 75 of its active counterparts, in that 70% has been annexed with CSA. Benefits resulting from application of netting clauses amount to 81%, i.e. total positive NPV exposure in the amount of PLN 375 million gets reduced to PLN 73 million after netting.

Cooperation with non-financial clients is based on standard, internally developed framework agreement, that specifies: rights and obligations of both sides, in particular the list of triggers indicating deterioration of client's financial situation, situations and instruments to be used by the client to provide additional collateral should the limit be breached or expired, or if other important clauses of the agreements are broken; mechanism of settlement compensation in case of early termination. The benefits from compensation in case of corporate clients amounts to PLN 6 million, i.e. 48% of exposure. The level of collateral as of the end of 2013 that should be provided by Bank in case of significant decrease of its credibility is estimated in the level of PLN 45 m.

The table below presents structure of residual maturity of derivatives' portfolio, its positive, negative (and net) valuation (that can be perceived as a concentration of market risk split into instruments) and netting benefits as at end of 2013.

Tab. Exposure in derivatives (part 1) – 31.12.2013 in PLN thou.

type of instrument	notional							
	up to 1M	1-3M	3-6M	6-12M	1-2Y	2-5Y	5Y+	total
with banks	**3 572 787**	**2 910 284**	**7 495 572**	**7 220 756**	**3 565 620**	**1 949 280**	**733 144**	**27 447 443**
FRA	0	400 000	84 540	171 723	0	0	0	656 263
IRS / CIRS / OIS	2 374 820	2 032 080	6 580 912	3 032 156	3 565 620	1 949 280	733 144	20 268 012
FX Swap	1 197 967	472 042	829 440	4 016 877	0	0	0	6 516 327
FX Options[1], incl.:	0	6 162	0	0	0	0	0	6 162
- vanilla	0	0	0	0	0	0	0	0
- exotic	0	6 162	0	0	0	0	0	6 162
Commodity Swap[2]	0	0	680	0	0	0	0	680
with non-banks	**108 136**	**101 869**	**269 580**	**28 347**	**37 475**	**321 021**	**5 007**	**871 434**
IRS / CIRS	0	0	200 000	0	32 084	321 021	5 007	558 111
FX Forward	66 696	41 861	25 503	7 824	5 391	0	0	147 276
FX Forward (NDF)	41 440	53 845	43 378	20 524	0	0	0	159 187
FX Options[1], incl.:	0	6 162	0	0	0	0	0	6 162
- vanilla	0	0	0	0	0	0	0	0
- exotic	0	6 162	0	0	0	0	0	6 162
Commodity Swap[2]	0	0	698	0	0	0	0	698
total	**3 680 923**	**3 012 153**	**7 765 152**	**7 249 103**	**3 603 095**	**2 270 301**	**738 151**	**28 318 877**

1) Interbank options include structured deposits embedded options' hedge
2) Commodity interbank swaps matched with clients respective transactions by underlying commodity amount, not by their notional value

Tab. Exposure in derivatives (part 2) – 31.12.2013 in PLN thou.

type of instrument	NPV			netting benefits	
	NPV +	NPV -	NPV net	NPV	%
with banks	**374 518**	**-302 259**	**72 759**	**301 757**	**80,57%**
FRA	165	-61	105	61	36,82%
IRS / CIRS / OIS	262 832	-206 384	56 448	206 384	78,52%
FX Swap	111 381	-95 671	16 208	95 172	85,45%
FX Options, incl.:	136	-136	0	136	100,00%
- vanilla	0	0	0	0	0,00%
- exotic	136	-136	0	136	100,00%
Commodity Swap	4	-7	-3	4	100,00%
with non-banks	**11 675**	**-10 066**	**1 678**	**5 614**	**48,09%**
IRS / CIRS	10 263	-4 223	6 040	4 223	41,15%
FX Forward	305	-2 462	-2 088	305	100,00%
FX Forward (NDF)	951	-3 245	-2 294	951	100,00%
FX Options, incl.:	136	-136	0	136	100,00%
- vanilla	0	0	0	0	0,00%
- exotic	136	-136	0	136	100,00%
Commodity Swap	21	0	21	0	0,00%
total	**386 194**	**-312 324**	**74 437**	**307 371**	**79,59%**

No credit provisions are being made on off-balance receivables, in particular resulting from derivative instruments, unless the transaction is terminated before its contractual maturity and is not settled – then it is converted into overdue receivable and standard provisioning procedures are then applied. In order to reflect in Bank's P&L account the risk of such event taking place, since December 2008 Bank BGŻ applies monthly adjustment of fair value of non-financial counterparts' transactions. The model that is being used scales the regular fair value, treated in this process as an exposure at default (EAD), by the factor resulting from expected probability of default given by internal rating of the counterparty multiplied by expected level of loss assuming partial successful recovery (LGD). Such approach is applied to majority of counterparts; however using expert knowledge with regard to individual PD and LGD estimates is also possible. Above described adjustment takes into account cash collaterals provided by the clients as well as netting clauses in accordance with framework agreements.

As of 31.12.2013, the adjustment of fair value with credit risk component amounted to PLN 499 thus.

I. OPERATIONAL RISK

The gross losses resulting from the operational risk events reported in 2013 have been presented in the table below by event types and categories within types. The amount of gross loss means a sum of losses resulting from the operational risk incidents registered in the Bank's internal database, both realized and not realized (in the Bank's opinion possible to be realized) without taking into account reductions resulting from amounts recovered from the insurance.

Tab. Gross losses resulting from operational risk events reported in 2013 (in PLN '000)

event type / event category within event type	PLN '000
1.Internal frauds	**2 158**
Theft and internal fraud	2 158
2.External frauds	**3 350**
Theft and external fraud	2 871
Systems security	479
3.Employment practices and workplace safety	**194**
Employee relations	194
4.Clients, products and business practices	**460**
Customer service, disclosure of information about clients, commitment to customers	265
Improper business or market practices	85
Product defects	109
Customers classification and exposures	1
5.Damages to physical assets	**320**
Disasters and other events	320
6.Business disruption and system failures	**1 082**
Systems	1 082
7.Execution, Delivery and Process Management	**9 005**
Transaction capture, execution & maintenance	8 604
Monitoring and reporting	1
Customer intake and documentation	276
Trade counterparties	124
total	**16 569**

In order to mitigate risk the Bank strengthens processes and mechanisms aimed at limiting level of risk. This includes amongst others prevention of frauds to the Bank's detriment and control of correctness of execution of processes in which the irregularities are identified. Moreover, the Bank regularly verifies and assesses the internal control environment as well as determines actions improving the control mechanisms efficiency.

J. CAPITAL EXPOSURES NOT INCLUDED IN THE TRADING BOOK

Equity instruments outside the trading book comprise shares and investments of a strategic or infrastructural character. Valuation of these exposures is done by estimation of their fair value based on reliable information as of possible sale price to be obtained, or based on net assets. In case of lack of observable quotations on active markets and no possibility to reliably estimate fair value using alternative methods, such assets are carried at cost less any impairment.

As of the 31st of December 2013 carrying amount of the exposures amounted to PLN 5.4 million, including PLN 4.0 million instruments quoted on regulated markets.

As of 31st December 2013 the unrealized gains from revaluation equalled PLN 1.4 million. There were no losses/gains from sales and liquidation.

K. REMUNERATION POLICY FOR THE BANK'S MANAGEMENT

Process of setting a policy according to variable components of remuneration

In the Bank are functioning the Management Board Remuneration Policy and the Remuneration Policy for all employees, including employees in management positions, having a significant impact on the risk profile of the Bank. Policies have been developed in accordance with the recommendations of Resolution No. 258/2011 and approved by the Supervisory Board on 21 June 2012.

In the above mentioned Policies were introduced changes, approved by the Supervisory Board on 19 December 2012, 29 March 2013, and 18 December 2013. The update of Policies was related to changes in the definition of the retention period and the deferral period, and the introduction to the Policy definition of significant impact on the risk profile of the Bank used in the process of identifying managerial positions within the meaning of Resolution No. 258/2011.

The participants of the process of determining and updating the Remuneration Policies have been identified in the table below:

participants in the process of determining and updating the remuneration policy	role in the process
Performance Management and Compensation Department with a support from an external consultant	development of policies, recommending for approval of the Management Board
Performance Management and Compensation Department	preparation of amendments to the policy, recommendation for the approval of the Management Board
The Legal Department	legal support, compatibility with the provisions of labor law
The Management Board	supervision of the development and approval of policies and changes to policies
Human Resources and Remuneration Committee	Giving opinion to the Supervisory Board - supporting Supervisory Board in the policy approval process and changes to policies
The Supervisory Board	approval of the policy and changes to policies

The Bank has established Human Resources and Remuneration Committee, which supports the Supervisory Board in carrying out supervisory responsibilities in the area of human resource management by monitoring and supervision of key processes, in particular: succession plans, professional development of employees, remuneration policies. The Committee shall draw for the Supervisory Board opinions and recommendations on, among others, conditions of employment of the members of the Management Board, including the amount of established and awarded variable remuneration.

The Human Resources and Remuneration Committee consists of at least two members appointed out of the members of the Supervisory Board. In addition Chairman of the Audit Committee participates in the works of giving opinion on the remuneration policy, its implementation and evaluation in the Bank. The Committee is managed by the chairman of the Supervisory Board.

Setting remuneration level

BGŻ carries a rational, sustainable and controlled remuneration policy, ensuring its compliance with the strategy, acceptable level of risk and standards and core values of the Bank. The remuneration policy reflects the Bank's customer orientation while taking into account the long-term welfare of the Bank and socially accepted practice in the area of remuneration. It is compatible with the relevant laws and regulations.

The remuneration policy applies to all employees. In particular determines conditions and rules for setting, granting and paying the performance-based, variable remuneration to employees in managerial positions which have significant impact on the risk profile of the Bank (within the meaning of KNF Resolution No. 258/2011).

The main principles for remuneration setting (including performance-based remuneration) are:

1) The ratio between fixed and variable remuneration is balanced enough to allow for setting a fully flexible variable remuneration policy, including the possibility of reducing or (where justified) of not granting variable remuneration components at all.
2) Variable remuneration (performance-based) is not granted and paid in cases if the level of earnings is lower than the 85% of earnings assumed in the financial plan.
3) Variable remuneration is set in such a way that it adequately reflects the results in terms of balanced development of the Bank (taking into account the Bank's risk) and is not a reward for lack of performance.

   While determining the variable remuneration the following issues are taken into account:

   a. avoiding situations in which variable remuneration limits the possibilities to strengthen regulatory capital, adequacy ratio and equity,
   b. including risk assessment and necessary mitigation measures to achieve the desired risk profile,
   c. referring short-term financial results to the long term ones.

   Risk assessment applies to both quantitative risk-adjustments (e.g. based on economic capital and RAROC) and qualitative ones (e.g. based on available information on risk management and compliance).
4) In order to ensure that the variable remuneration is in line with the risk profile of BGŻ, the minimum requirement is: after the calculation and payment of variable remuneration (including

deferred remuneration) basic funds are equal to or higher than the threshold specified in regulations (Basel, guidelines and resolutions by Financial Supervisory Commission). If this minimum requirement is not met, the variable remuneration (including deferred remuneration) is not due to the extent that violates the requirement.

Performance criteria entitling to the variable components of remuneration

1) The amount of the variable remuneration granted to persons holding managerial positions having significant impact on bank's risk profile is determined based on the individual employee's performance, performance of the relevant business unit and the performance of the Bank as a whole, taking into account the influence of risks. Weights for these performance components are determined in advance and are adequately balanced with Risk Takers' responsibilities. The variable remuneration is based on both financial and non-financial performance criteria. Objectives related to Bank's performance take into account long-term risks, liquidity and capital levels.
2) The amount of variable remuneration awarded to persons in managerial positions having significant impact on bank's risk profile responsible for monitoring functions is based on the individual employee's job-related performance targets. Financial criteria are not connected with financial results of the areas that are monitored by a given employee in the monitoring function.
3) Variable remuneration is not granted and paid if the employee does not reach a minimum level of achievement of individual objectives.
4) The performance assessment is performed on a three-year basis in order to ensure that the actual payment of performance-related remuneration is spread over a period which takes into account the underlying business cycle of the Bank and its business risks.

Main parameters and rules for determining the remuneration of persons holding managerial positions which have significant impact on the risk profile in the Bank, including a relationship between the remuneration and the results

1) Maximum amount of variable remuneration, the base value for the variable remuneration and the amount of the variable remuneration granted to Risk Takers are determined by the Management Board.
2) The ratio between fixed pay and variable pay is adequately balanced and the fixed pay represents a sufficiently high proportion of the total remuneration to allow for creation of a fully flexible policy on variable remuneration components, including the possibility to decrease or pay no variable remuneration (malus).
3) While determining fixed and variable pay for persons holding managerial positions having significant impact on bank's risk profile responsible for monitoring functions fixed pay is preferred and variable pay is capped at 50% of fixed pay.
4) The amount of the variable pay awarded to Risk Takers is determined basing on the individual employee's performance, performance of the relevant business unit and the performance of the Bank as a whole.

5) Part of the variable pay is paid out after the performance period while the rest of the payment is deferred.
6) While granting total remuneration to employees, Management Board takes into account the long-term business strategy of the BGŻ, the continuity of its activities and the interests of all stakeholders. Variable pay is awarded in a restraint way and the construction of the remuneration motivates behaviours that are compliant with BGŻ's objectives and risk profile of the Bank.
7) Maximum variable pay including bonuses for Risk Takers amounts to 100% of fixed pay.
8) Maximum variable pay for the employees in monitoring functions, including Risk Takers amounts to 50% of fixed pay.

Aggregate quantitative information on remuneration divided into business lines used in the Bank

The following table presents quantitative information on remuneration of persons holding managerial positions having significant impact on bank's risk profile divided into business lines used in the Bank.

business lines	total cash
Retail Banking	2 581 068
Corporate Banking	7 632 581
Risk and Support	22 089 882

Aggregate quantitative information on remuneration of Risk Takers (persons holding managerial positions within the meaning of KNF Resolution)

The following table presents aggregate quantitative information on remuneration of Risk Takers (persons holding managerial positions having a significant impact on the risk profile of the Bank within the meaning of KNF Resolution).

information on remuneration	managerial positions in the Bank:	
	specified in § 14 point 6) letter a of Appendix 1 to the KNF Resolution	specified in § 14 point 6) letter b of Appendix 1 to the KNF Resolution
number of people	27	13
fixed remuneration	23 238 533	2 976 483
variable remuneration for 2013 (deferred and non-deferred)	4 971 900	373 898
non-deferred variable remuneration:		
cash - paid out	1 384 600	373 898
phantom shares - granted (number)	16 977	0
deferred variable remuneration - granted:		
cash	113 583	0
phantom shares (number)	2 011	0

deferred variable remuneration - non granted:		
cash	2 178 642	-
phantom shares (number)	34 421	-
payments related to taking up and termination of employment *:		
amount	3 826 000	140 651
number of people	3	2

*the highest payment for one person was 3 300 000 PLN

Bank once a year, till January 31, communicate to the Financial Supervision Commission data on the number of persons employed therein whose total remuneration during the previous year exceeded the equivalent of 1 million, together with information on the positions taken by these people and the main elements of salary, of bonuses and long-term rewards and discharged pension contributions.

In 2013, none of the employees of the Bank has reached such remuneration.